Special Report

The Not So Golden Years

Credit Implications of GASB 45

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Related Research

- "Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits," Sept. 18, 2003
- "Local Governments Pressured by Rising Employee Health Care Costs," Dec. 13, 2004

■ Summary

A new public sector accounting standard touches on three hot topics: skyrocketing health care costs, the ongoing national debate over retirement security, and the recent emphasis on greater financial disclosure. Governmental Accounting Standards Board (GASB) Statement No. 45 relates to other post-employment benefits (OPEB) — payments and services provided for retirees other than pensions. OPEB consist mainly of retiree health care benefits. GASB 45 applies the accounting methodology used for pension liabilities (GASB 27) to OPEB and is similar in concept to an accounting standard adopted for the private sector in the mid-1990s.

The new standard, to be implemented beginning in fiscal 2008 for many large governments, is timely given the aging demographics of the governmental work force. It also reflects the consistent efforts of the GASB to improve financial statement transparency and align public accounting more closely with that of the private sector.

GASB 45 does not increase costs of employment, but attempts to more fully reveal them by requiring governmental units to include future OPEB costs in their financial statements. Under current practice, nearly all governments pay only the cost of OPEB due in the current year, with no effort made to accumulate assets to offset future benefit costs. While not mandating funding, GASB 45 does establish a framework for prefunding of future costs.

Amounts required to prefund OPEB on an actuarially sound basis are likely to significantly exceed annual pay-as-you-go outlays for these benefits. Many actuaries believe, bolstered by preliminary studies done on behalf of a few proactive governments, that actuarially determined annual contributions could be five to 10 times higher than current expenses in many cases.

Fitch Ratings views GASB 45 as a positive step toward more fully illuminating governmental obligations to retirees, but acknowledges the inherent tension between allocating scarce resources toward critical government services today and meeting the funding requirements for retirement benefits that might not be due for decades. Fitch anticipates that governments will thoroughly review retiree benefit programs and that responses to OPEB funding challenges will vary considerably. However, Fitch expects many governments will approach GASB 45 in much the same way they responded to the adoption of pension system actuarial and accounting standards, by steadily ramping up annual contributions to actuarially determined levels, altering benefit plans, or taking other actions to ensure long-term plan solvency.

Credit Highlights

- Governmental Accounting Standards Board (GASB) Statement No. 45 will be the accepted accounting practice for governments as of its implementation dates. Failure to comply would prevent auditors from releasing a "clean" audit opinion.
- The switch to actuarial funding from a pay-as-you-go practice may have a sizable fiscal impact. However, Fitch Ratings believes that meeting actuarial funding requirements for other post-employment benefits (OPEB) will be a stabilizing factor and protective of credit over time.
- Fitch expects a wide range of unfunded liability positions to result as GASB 45 is implemented, reflecting the variability of benefits offered around the U.S. Annually required contributions are likely to place disparate burdens on the budgetary resources of state and local governments.
- Initially, Fitch's credit focus will be on understanding each issuer's liability and its plans for addressing it. Fitch also will review an entity's reasoning in developing its plan. An absence of action taken to fund OPEB liabilities or otherwise manage them will be viewed as a negative rating factor.
- For issuers choosing to ramp up annual contributions to reach full funding of actuarially determined levels, Fitch recognizes that a rising net OPEB obligation in the short term may be a by-product. Such an increase, taken in the context of a sound OPEB funding plan, will not by itself affect credit ratings.
- Fitch does not expect OPEB plan funding ratios to reach the generally high levels of pension systems for many years, but steady progress toward reaching the actuarially determined annual contribution level will be critical to sound credit quality.
- Assumptions play a crucial role in calculating plan assets and liabilities. As actuarial standards for OPEB plans become clear, Fitch will review the underlying assumptions and will view negatively any that are overly aggressive. When applicable, assumptions should be consistent with those adopted for the plan sponsor's pension system.
- Fitch will view OPEB liabilities, like pensions, as soft liabilities that fluctuate based on assumptions and actual experience. Reality dictates that an entity may opt to defer OPEB funding in times of budget stress. However, indefinite deferrals are damaging to credit quality. While not debt, pension and OPEB accumulated costs are legal or practical contractual commitments that form a portion of fixed costs. Long-term deferral of such obligations is a sign of fiscal stress that will be reflected in ratings.

Failure to make actuarially determined OPEB plan contributions will most likely result in rising net OPEB obligations, which like rising net pension obligations are a deferral of financial responsibility. Therefore, over time, a lack of substantive progress in funding and managing OPEB liabilities or a failure to develop a realistic plan to meet annual OPEB contributions could adversely affect an issuer's credit rating. Conversely, in Fitch's opinion, the prudent accumulation of assets in a trust account outside the general fund and well in advance of pay-as-you-go cost escalations can avoid or forestall liquidity problems or tax capacity concerns that might lead to credit deterioration.

Implementation Schedule

GASB 45 will be phased in, beginning with the largest governments, effective:

- Fiscal periods beginning after Dec. 15, 2006 for governments with annual revenue greater than $100 million.
- Fiscal periods beginning after Dec. 15, 2007 for governments with annual revenue between $10 million and $100 million.
- Fiscal periods beginning after Dec. 15, 2008 for governments with revenue under $10 million.

Exploring GASB 45

GASB 45 furthers the effort to disclose the total cost of compensation earned by public sector employees. Some of this cost, specifically the salaries and related benefits of active workers, is already recognized on the statement of revenues, expenditures, and changes in fund balance (income statement) prepared annually. Similarly, the cost of pension benefits for current and retired workers is recognized through the implementation of GASB 27, which requires income statement recognition of annual employer contributions to pension systems and balance sheet recognition of net pension obligations (most often as a liability, but theoretically an asset). GASB 45 largely adopts the accounting and actuarial valuation methodologies used for pensions, making minor adjustments to reflect the different nature of OPEB and the reality that very few governments have funded OPEB plans.

OPEB primarily relate to retiree health care, but can also include life insurance and other benefits. OPEB contributions by employers generally take the form of direct indemnity payments or full or partial cost-sharing of annual insurance premiums, but can also take the form of an implicit subsidy. This occurs when retirees pay a health insurance premium that is based on a larger risk pool, thereby benefiting from a lower premium rate than if they had to pay the full age-based premium.

Under GASB 45, governments providing benefits to more than 200 plan members are required to have an actuarial valuation of their OPEB plans done every two years. Most governments accessing the capital markets fall under this requirement. The OPEB plan is defined as whatever constitutes the “substantive plan,” incorporating written and documented plan elements, as well as nondocumented elements that have been communicated and understood between the employer and employees. The actuarial valuation determines the actuarial present value of future liabilities — in essence, the amount that, if invested at the valuation date, would be sufficient to meet all liabilities, assuming embedded assumptions hold true.

From the actuarial valuation, an annually required contribution (ARC) is determined. The ARC is the portion allocated to the current year of the amount needed to pay both the normal costs (current and future benefits earned) and to amortize the unfunded liability (past benefits earned but not previously provided for). GASB 45 requires amortization of unfunded liabilities over a maximum of 30 years.

GASB 45 requires an accounting of a government’s compliance in meeting its ARC. Contributions in an amount less than the ARC result in a net OPEB obligation, which is to be recorded as a liability on the governmentwide financial statements and full accrual-based fund statements. Only the employer’s payments count toward the ARC; employee matching payments do not. The direct payment of benefits counts as a contribution toward the ARC. However, since nearly all plans will have some past service liability to amortize, simply continuing with pay-as-you-go funding is likely to result in rising net OPEB obligations.

Unlike GASB 27, which covers employer accounting for pensions, under GASB 45 there will be no net OPEB obligations reported at transition (unless a government volunteers to record one). Unfunded OPEB plan liabilities will be present as governments begin to implement the standard, but governments will be required to disclose their compliance in meeting the ARC only on a going-forward basis. The footnotes to the financial statements will include information on compliance in meeting ARCs, the cumulative net OPEB obligation, and the actuarial funding ratio of the OPEB plan (assuming a trust account is established).

■ OPEB Trust Funds

A critical element to making OPEB plans affordable and actuarially sound is GASB 45’s requirement that, in order for actuaries to permit the use of a long-term investment return assumption, governments must set aside plan assets in an irrevocable trust. Funds accumulated or earmarked but held outside an irrevocable trust are limited to an investment return assumption consistent with general government investments, which are typically shorter in duration and lower in yield. Partially funded plans are required to use a blended rate, based on the proportion of contributions being used for asset accumulation versus payment of current benefits.

The ramifications for OPEB plan valuation are enormous, as long-term return assumptions are usually at least twice those of short-term investments. The higher the investment return assumption (discount rate), the lower the present value of future liabilities and the corresponding ARC will be.

Governments and actuaries are currently exploring different types of trust mechanisms, with no clear consensus emerging to date. Options include 401(h) accounts, voluntary employee benefit accounts, section 115 governmental trusts, and others. The type of trust account used may vary depending on the design of the OPEB plan. One consideration for governments may be weighing the financial benefits of establishing a trust against the legal and human resources management implications. Many governments reserve the right to unilaterally revoke OPEB. Establishing a trust fund may be seen as conferring a permanency to the benefit plan that might not be intended.

■ Role of Assumptions

As they do for pension systems, economic and demographic assumptions will play a critical role in determining the magnitude of OPEB plan liabilities (and eventually assets). Beyond the discount rate assumption discussed in the previous section, projections of health care costs and retirement rates and ages will be crucial to OPEB plans.

Health care costs have risen rapidly since the mid-1990s, with double-digit growth rates in some years. The pace of health care cost growth outstrips the salary and general inflation assumptions embedded in pension plan valuations, making OPEB liability growth potentially more volatile. Fitch expects initial variability in medical inflation assumptions, with actuaries making adjustments over time based on experience.

Retirement rate assumptions project how many plan members will leave active service and begin collecting OPEB during the valuation period. Studies have shown that the public sector work force is disproportionately made up of baby boomers, who are nearing retirement age. The pace at which they retire will have a significant effect on liability valuations and could even affect investment performance, as plan managers may have to adjust investment allocations to maintain liquidity sufficient to meet current benefit expenses. Retirement age is also important, given the existence of Medicare. In most cases, OPEB health care costs would be at least partially offset by Medicare. However, retirement age rules vary significantly among and within governments, with some plans having to carry OPEB for 10–15 years until Medicare eligibility is reached, and others facing much shorter exposure.

Implementation Issues

GASB 45 potentially creates legal, technical, and policy issues for the public sector.

Defining the "Substantive Plan": Determining the precise definition of an OPEB plan is the task of the employer, in consultation with the actuary. Written documentation of the benefit plan may or may not accurately reflect the currently understood version of the plan. Employers have a financial interest in more narrowly defining the substantive plan, which may put them at odds with employee groups. Legal challenges or labor grievances can be envisioned.

Legal Status of OPEB: In many states and localities, pension benefits are constitutionally protected, statutorily defined, or otherwise codified. While OPEB may have the same status in some jurisdictions, many governments have greater administrative control over OPEB. If employers seek to modify or eliminate OPEB for some workers or retirees, legal clarification may be required.

Medicare Part D: The implementation of the new prescription drug benefit under Medicare is under way and scheduled to go into effect Jan. 1, 2006. Integration with government OPEB plans will take time and will be complex. It is not clear at present whether this federal program will provide a financial benefit to or impose additional costs on state and local governments.

Labor Relations: Faced with potentially large costs to prefund OPEB plans, governments may seek concessions from active and retired employees. Conflicts could lead to work stoppages or recruitment and retention problems. Fitch expects such difficulties to appear in the more heavily unionized areas of the country.

Potential Funding Solutions

Governments will likely explore switching employees to a defined contribution system for OPEB. Once the government makes its scheduled contribution to employees or beneficiaries, all risk is transferred to the employee. While an attractive option for employers, it is likely achievable only for new hires, as existing beneficiaries have an interest in retaining the current system. Prolonged resistance by employee groups to defined contribution pension funding underscores this difficulty.

Governments facing large unfunded liabilities and steep ARCs may consider OPEB funding bonds. However, state laws are generally not explicit regarding issuing bonds for this purpose, creating a potential impediment to capital financing for OPEB. If legally allowable, OPEB funding bonds may be structured in the same manner as pension obligation bonds, which attempt to take advantage of the interest rate differential between taxable municipal bonds and the assumed investment return on plan assets. Bonds could be issued to fund all or a portion of a sponsor's unfunded OPEB liability, with the hope that the debt service on the bonds would be less than what the sponsor would otherwise have to pay in annual OPEB ARC costs over the long term.

Fitch believes that OPEB funding bonds, if used moderately and in conjunction with a prudent approach to investing the proceeds and other plan assets, can be a useful tool in asset-liability management. However, a failure to follow balanced and prudent investment practices could expose the plan sponsor to market losses.

Because a sponsor's unfunded OPEB liability will be factored into the rating, bond issuance would simply move the obligation from one part of the governmentwide or full accrual-based fund financial statements to another. However, Fitch notes that OPEB or pension funding bonds create a true debt, one which must be paid on time and in full, rather than a softer liability that can be deferred or rescheduled from time to time during periods of fiscal stress. Consequently, issuing bonds to fund an OPEB plan could have a significant effect on financial flexibility over time.